

***Veterans Debenture Revenue
Fund, Department of Veterans
Affairs, State of California***

*Financial Statements for the Years
Ended June 30, 2006 and 2005, and
Independent Auditors' Report*

INDEPENDENT AUDITORS' REPORT

California Veterans Board
State of California
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Debenture Revenue Fund (the "Fund"), Department of Veterans Affairs of the State of California (the "Department") as of June 30, 2006 and 2005, and the related statements of revenues, expenses and changes in fund equity, and of cash flows for the years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Fund as of June 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, the financial statements present only the Fund and are not intended to present the financial position of the Department of Veterans Affairs of the State of California or the results of its operations and cash flows of its proprietary funds.

Management's Discussion and Analysis on pages 2 through 5, is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards Board. The supplementary information is the responsibility of the Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and we do not express an opinion on it.

Deloitte + Touche LLP

October 10, 2006

VETERANS DEBENTURE REVENUE FUND, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

Introduction & Overview – Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California

This discussion and analysis presents the highlights of financial activities and financial position for the Veterans Debenture Revenue Fund (the "Fund"), Department of Veterans Affairs, State of California (the "Department"). The analysis is designed to provide readers with information that the Fund's management believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations. It is intended to help readers see the Fund through the eyes of management. It is further designed to provide context for the financial statements and information about the Fund's operations and cash flows.

Management's Discussion and Analysis ("MD&A") is based on currently known facts, decisions, and conditions that existed as of the date of the independent auditors report.

The Fund was established for the maintenance of a Bond Reserve Account as required by the revenue bond resolution of the Department. The resolution requires a reserve in an amount not less than three percent of the aggregate outstanding principal of all Revenue Bonds with interest rates fixed to maturity held by the Department.

Fiscal Year 2006 Compared to Fiscal Year 2005

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2006 and June 30, 2005, (dollars in thousands) and the change from year to year:

	2006	2005	Change	% Change
ASSETS				
Cash and cash equivalents	\$ 12,517	\$ 9,802	\$ 2,715	28 %
Investments	24,562	27,277	(2,715)	(10)%
Interest receivable	489	489	-	0 %
TOTAL ASSETS	\$ 37,568	\$ 37,568	\$ -	0 %
LIABILITIES & FUND EQUITY				
Noncurrent liabilities—Bond reserve due to the				
Veterans Farm and Home Fund of 1943	\$ 37,568	\$ 37,568	\$ -	-
Fund equity	-	-	-	-
TOTAL LIABILITIES AND FUND EQUITY	\$ 37,568	\$ 37,568	\$ -	0 %

Assets, Liabilities and Fund Equity

During fiscal year 2006, the Department retired \$25,715,000 of outstanding Revenue bonds of the Veterans Farm and Home Building Fund of 1943. As of June 30, 2006, the Department has \$124,635,000 of Revenue bonds with variable interest rates. The interest rate for the variable rate bonds is 3.87% as of June 30, 2006. The reserve balance in the Fund remains unchanged at \$37,567,500 from last fiscal year.

Condensed Statements of Revenues and Expenses

The following table presents the statements of revenues and expenses for the Fund for the years ended June 30, 2006 and 2005, (dollars in thousands) and the change from year to year:

	2006	2005	Change	% Change
REVENUES—Income from investments	<u>\$ 2,022</u>	<u>\$ 2,034</u>	<u>\$ (12)</u>	(0.6)%
EXPENSES—Transfers out to Veterans Farm and Home Building Fund of 1943	<u>2,022</u>	<u>2,034</u>	<u>(12)</u>	(0.6)%
EXCESS OF REVENUES OVER EXPENSES	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	-
FUND EQUITY—Beginning of year	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	-
FUND EQUITY—End of year	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>	-

Revenues & Expenses

All income generated by the Fund represents amounts due to the Farm and Home Fund and accordingly has been reflected as operating transfers out in the statements of revenues, expenses and changes in fund equity.

Fiscal Year 2005 Compared to Fiscal Year 2004

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2005 and June 30, 2004, (dollars in thousands) and the change from year to year:

	2005	2004	Change	% Change
ASSETS				
Cash and cash equivalents	\$ 9,802	\$ 3,289	\$ 6,513	198 %
Investments	27,277	34,040	(6,763)	(20)%
Interest receivable	489	239	250	105 %
TOTAL ASSETS	<u>\$ 37,568</u>	<u>\$ 37,568</u>	<u>\$ -</u>	-
LIABILITIES & FUND EQUITY				
Noncurrent liabilities—Bond reserve due to the Veterans Farm and Home Fund of 1943	\$ 37,568	\$ 37,568	\$ -	-
Fund equity	-	-	-	-
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 37,568</u>	<u>\$ 37,568</u>	<u>\$ -</u>	-

Assets, Liabilities and Fund Equity

In May 2005, a \$6,513,000 treasury note matured and the proceeds were reinvested in the State of California's Surplus Money Investment Fund. In addition, during fiscal year 2005, the Department retired \$90,970,000 of outstanding Revenue bonds of the Veterans Farm and Home Building Fund of 1943. The Department issued Home Purchase Revenue bonds totaling \$42,600,000 with fixed interest rates to economically refund previously issued Revenue bonds in the same amount. As of June 30, 2005, the Department has \$124,635,000 of Revenue bonds with variable interest rates. The interest rate for the variable rate bonds is 2.17% as of June 30, 2005. The Department issued \$221,475,000 of General Obligation bonds during fiscal year 2005. The reserve balance in the Fund remains unchanged at \$37,567,500 from last fiscal year.

Condensed Statements of Revenues and Expenses

The following table presents the statements of revenues and expenses for the Fund for the years ended June 30, 2005 and 2004, (dollars in thousands) and the change from year to year:

	2005	2004	Change	% Change
REVENUES—Income from investments	<u>\$ 2,034</u>	<u>\$ 2,009</u>	<u>\$ 25</u>	1.2 %
EXPENSES—Transfers out to Veterans Farm and Home Building Fund of 1943	<u>2,034</u>	<u>2,009</u>	<u>25</u>	1.2 %
EXCESS OF REVENUES OVER EXPENSES	<u>-</u>	<u>-</u>	<u>-</u>	-
FUND EQUITY—Beginning of year	<u>-</u>	<u>-</u>	<u>-</u>	-
FUND EQUITY—End of year	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	-

Revenues & Expenses

All income generated by the Fund represents amounts due to the Farm and Home Fund and accordingly has been reflected as operating transfers out in the statements of revenues, expenses and changes in fund equity.

**VETERANS DEBENTURE REVENUE FUND
DEPARTMENT OF VETERANS AFFAIRS,
STATE OF CALIFORNIA**

**BALANCE SHEETS
JUNE 30, 2006 AND 2005**

	2006	2005
ASSETS		
CURRENT ASSETS:		
Cash in State Treasury	\$ 800	\$ 800
Investments in State of California's Surplus		
Money Investment Fund (at fair value)	12,516,000	9,801,000
Investment agreements (at cost)	24,561,500	27,276,500
Interest receivable—Investments	113,691	131,642
Due from other funds	<u>375,509</u>	<u>357,558</u>
TOTAL	<u>\$ 37,567,500</u>	<u>\$ 37,567,500</u>
LIABILITIES AND FUND EQUITY		
NONCURRENT LIABILITIES—Bond reserve due to the		
Veterans Farm and Home Building Fund of 1943	\$ 37,567,500	\$ 37,567,500
FUND EQUITY	<u>-</u>	<u>-</u>
TOTAL	<u>\$ 37,567,500</u>	<u>\$ 37,567,500</u>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND
DEPARTMENT OF VETERANS AFFAIRS,
STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN FUND EQUITY
YEARS ENDED JUNE 30, 2006 AND 2005**

	2006	2005
REVENUES—Income from investments	\$ 2,021,729	\$ 2,034,038
EXPENSES—Transfers out to Veterans Farm and Home Building Fund of 1943	<u>2,021,729</u>	<u>2,034,038</u>
EXCESS OF REVENUES OVER EXPENSES	-	-
FUND EQUITY—Beginning of year	<u>-</u>	<u>-</u>
FUND EQUITY—End of year	<u>\$ -</u>	<u>\$ -</u>

See notes to financial statements.

**VETERANS DEBENTURE REVENUE FUND
DEPARTMENT OF VETERANS AFFAIRS,
STATE OF CALIFORNIA**

**STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2006 AND 2005**

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from investment income	2,021,729	1,783,678
Payments to other funds	<u>(2,021,729)</u>	<u>(2,034,038)</u>
Net cash used for operating activities	<u>-</u>	<u>(250,360)</u>
CASH FLOWS FROM INVESTING ACTIVITIES—Net increase in investment securities	<u>-</u>	<u>250,360</u>
NET INCREASE IN CASH IN STATE TREASURY	-	-
CASH IN STATE TREASURY:		
Beginning of year	<u>800</u>	<u>800</u>
End of year	<u><u>800</u></u>	<u><u>800</u></u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Excess of revenues over expenses	-	-
Adjustments to reconcile to net cash used by operating activities—effect of changes in assets and liabilities:		
Decrease in interest receivable	17,951	58,836
Increase in due from other funds	<u>(17,951)</u>	<u>(309,196)</u>
NET CASH USED FOR OPERATING ACTIVITIES	<u><u>-</u></u>	<u><u>(250,360)</u></u>

See notes to financial statements.

VETERANS DEBENTURE REVENUE FUND

DEPARTMENT OF VETERANS AFFAIRS,

STATE OF CALIFORNIA

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED JUNE 30, 2006 AND 2005

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of the Fund—The California Department of Veterans Affairs (the “Department”) is a separate legal entity, acting as a Cabinet level agency of the State of California. A seven-member California Veterans Board (the Board) has policy oversight of the operations of the Department. The Board’s membership consists of the seven members, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Department is authorized to issue revenue bonds to fund low-interest farm and home loan contracts with veterans living in California.

In December 1997, the Department amended the revenue bond resolution provision regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund (the Fund). The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount not less than three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A, B and C Bonds, 1998 Series A Bonds, 1999 Series A and B Bonds, 2000 Series A, B and C Bonds, 2001 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds. With respect to the 2002 Series A Bonds, the Resolution requires an amount equal to at least five percent of the outstanding principal amount of such Revenue Bonds. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Veterans Farm and Home Building Fund of 1943 (Farm and Home Fund), at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Farm and Home Fund.

At June 30, 2006 and 2005, the liabilities of the Veterans Debenture Revenue Fund represent amounts due to the Farm and Home Fund and, accordingly, are included as a receivable in the financial statements of the Farm and Home Fund.

The financial statements represent only the activities of the Veterans Debenture Revenue Fund and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary funds. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

Use of Estimates in the Preparation of Financial Statements—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Accounting—The fund has been classified as a proprietary fund type for accounting purposes. Generally, revenues are recorded when earned and become measurable, and expenses are recognized as incurred.

Cash and Investments—All investments are reported at fair value except for nonparticipating fixed interest investment agreements which are valued using cost based measures. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the Surplus Money Investment Fund. Income from investments includes net unrealized appreciation or depreciation in the fair value of investments.

Revenues and Operating Transfers—Income from investments is recorded as earned. A corresponding operating transfer out is recorded to reflect the required transfer to the Farm and Home Fund.

2. CASH AND INVESTMENTS

Cash and cash equivalents—Cash in State Treasury represents amounts held in the Fund's general operating account with the State Treasury. These monies are pooled with the monies of other state agencies and invested by the State Treasurer's office. These investments are not individually identifiable. At June 30, 2006, the carrying amount of the Fund's deposits was \$12,516,800. At June 30, 2005, the carrying amount of the Fund's deposits was \$9,801,800.

Investments—Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund, and investment agreements with financial institutions rated within the top two ratings of a nationally recognized rating service.

The Fund's investment in four investment agreements of \$24,561,500 as of June 30, 2006, is carried at cost. All investment agreements are fixed rate contracts. The contracts mature from 2015 to 2028 and bear interest from 5.38% to 5.75%.

For the 2006 fiscal year, the Fund has implemented the GASB Statement No. 40, and in accordance, the Fund has no disclosures as to Custodial Credit Risk, Concentration of Credit Risk, and Interest Rate Risk. The GASB Statement No. 40 disclosures replace the investment risk categorization in the 2005 financials statements of the Fund.

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